A shopkeeper arranges prices of pulses in Delhi, India.

Global Financial Turmoil Tests Asia

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As the global financial crisis spreads, how will Asia weather the storm?

COMPARED with other regions, Asia appeared at first better positioned to weather the storm created by the global fiancial crisis, thanks to its substantial official reserves cushion, improved policy frameworks, and generally robust corporate balance sheets and banking sectors.

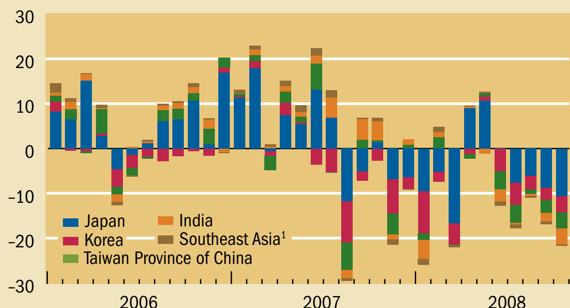
However, after the collapse of Lehman Brothers in mid-September and the ensuing rise in global risk aversion, the crisis spread to Asia and rattled many of its markets. Any hope that the region would escape the crisis unscathed has by now evaporated. With global growth expected to slow markedly next year and deleveraging to continue, Asia will likely face a difficult period ahead. How Asia withstands the shock of both slower global growth and a spreading financial crisis is critical not only for the region, but for the world as a whole.

Chart 1

Fleeing foreign capital

Since the start of the global credit crisis, risk-averse investors have been pulling their money out of Asian equity markets.

(net equity flows, billion dollars)



Source: Bloomberg LP.
[1]Indonesia, Philippines, Thailand, and Vietnam.

Asia's financial systems

Some important characteristics of Asia's financial systems protected them early on from the worst of the crisis. These systems tend to be bank dominated and generally have not engaged in the off-balance-sheet activities or invested in the illiquid securitized assets at the heart of the current crisis in advanced economies. Asian financial institutions overall have limited exposure to U.S. subprime mortgages and structured credit products from overseas, attributable in part to the more cautious risk management and the strengthening of the regulatory structure that resulted both from Japan's banking crisis in the late 1990s and the 1997 financial crisis in emerging Asia. Moreover, the region's derivative and structured products remain for the most part in relative infancy.

But given the region's large trade and financial integration with the rest of the world, investors' views of Asia soured as the global turmoil intensified and perceptions grew that the global economy was in for a major slowdown. Large net equity outflows have driven down stock prices sharply (see Chart 1). Asia-focused hedge funds have been among the worst performers worldwide, with their returns consistently below those of other emerging market funds.

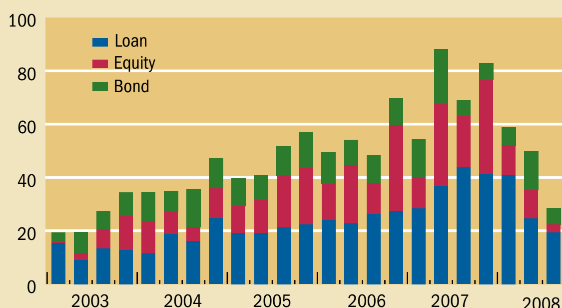
Capital outflows have also significantly weakened currencies in some countries, notably India, Korea, New Zealand, and Vietnam. And several countries have responded by intervening to support their currencies, in stark contrast to the past several years, when most Asian countries were concerned about the rapid *appreciation* of their currencies.

With the rise in global risk aversion, Asian governments, corporations, and financial institutions have found it more difficult to access the global financial markets (see Chart 2).

Chart 2

Frozen out

Asian borrowers—sovereign and private—are finding it ever harder to tap global financial markets.



Source: Bond, equity and loan database of the IMF through Dealogic.

Countries with banking systems that rely more on wholesale financing and less on retail deposits (Australia, India, Korea, New Zealand) have experienced a higher rise in borrowing costs, partly because of concerns they will face difficulties rolling over their debts. As a result of these tightened conditions, the region's private external financing has fallen sharply.

Domestic interbank and money markets have also come under stress from the global turmoil. In financial centers (Hong Kong SAR, Singapore, and Tokyo), interbank spreads over comparable government yields (so-called TED spreads) have risen, reflecting concerns about counterparty risk with foreign banks as well as a flight to quality. Spreads on credit default swaps for Asia—the cost of insurance against default on corporate bonds—have widened substantially (see Chart 3). The cash market for domestic structured products also remains effectively shut down as investors continue to turn away from securitized instruments. Most worrisome for a region highly dependent on external trade is the mounting evidence that trade financing is drying up. Finally, the global shortage of dollar liquidity is spilling over to affect local currency markets, such as those for swaps and repurchase agreements, leading to some market dysfunction and higher domestic funding rates.

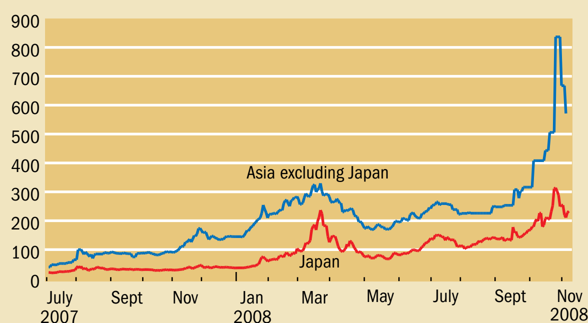
A range of policy responses

Policymakers have responded with a range of measures to stabilize financial conditions. For example, in addition to providing exceptional short-term liquidity, the Hong Kong Monetary Authority has taken steps to broaden the types of collateral it will accept and increase the attractiveness and maturity of its liquidity support. In India, the Reserve Bank sharply reduced the cash reserve requirement it imposes on banks to relieve pressures in the interbank market. Central

Chart 3

Credit risk rises

Spreads on credit default swaps for Asia, essentially the cost of credit default insurance, have risen dramatically since mid-2008.



Sources: Bloomberg; and IMF staff calculations.

Notes: Measured by iTraxx Indices. Spreads are the annual amount that an entity seeking protection must pay, expressed as a percentage of the value of the debt being protected. A basis point is 1/100th of a percentage point.

banks in Australia, India, and Korea have also tapped their official reserves to supply U.S. dollar liquidity through local markets for foreign exchange swaps (instruments that institutions use to insure against exchange risks when using funds in one currency to meet demands in another currency). Various central banks in the region have been assisted in their efforts by a swap arrangement with the U.S. Federal Reserve. Moreover, many countries have announced deposit guarantees and/or guarantees on banks' foreign debts.

What the region faces

With global financial conditions worsening, much depends on the ability of the domestic banking sector to provide sufficient and timely credit in an environment of slowing growth and rising market risk. So far, despite the financial stresses, conventional bank lending has held up reasonably well. Private credit growth has come down across the region, but remains robust—except in Vietnam, where credit expansion has decelerated in response to policy tightening. Although Asian banks have the benefit of relatively sound capital positions, the economic slowdown is likely to raise credit costs and could also scale back lending growth. Corporate default rates have risen in countries where domestic demand has weakened, pointing to a possible rise in bad loans ahead. Cooling housing markets in some countries could also affect bank asset quality. While a major deterioration in regional banking conditions is not expected, it cannot be excluded at this stage. In particular, there is a risk that the global slowdown will be deeper and more protracted than expected, leading to a large number of corporate defaults in the region.

Preparing for the worst

What can supervisors and regulators do to limit the risk of contagion from the global slowdown and credit turmoil? There is merit in a multipronged approach for Asia.

• ***Managing exposure to large leveraged institutions.*** The failures of several large distressed institutions in the advanced economies have raised concerns about potential exposure to other highly leveraged players, including those in Asia. Early disclosure of exposure can help ease market concerns and allow investors to differentiate across institutions and countries. (For example, the Japanese Financial Services Agency publishes holdings of subprime and other structured products by deposit-taking institutions.) Further defaults can be expected, and policymakers should review contingency plans, including addressing possible fallout on the interbank market and ensuring the adequacy of deposit insurance (or guarantees) and public recapitalization programs. In addition, greater cross-border collaboration among supervisors would help strengthen monitoring of financial distress from overseas and, where financial systems are interconnected, lay the groundwork for more effective coordinated actions.

• ***Enhancing liquidity risk management.*** Supervisors must ensure that banks follow proper regulatory standards for liquidity risk management—for example, through avoiding maturity mismatches. They also must ensure that banks perform stress testing and contingency planning that incorporate extreme events such as cutoffs of foreign financing. Central banks should also consider reviewing the range of available liquidity instruments, including in foreign currency, and the possibility of extending liquidity provision to a broader set of institutions and against a wider range of collateral.

• ***Safeguarding access to cross-border funding, including trade financing.*** Domestic banks depend heavily on foreign bank subsidiaries for U.S. dollar liquidity, as well as on foreign exchange swap markets, which have come under stress during periods of high risk aversion and, in turn, affected other local funding markets. To ensure smooth cross-border funding, regulators should examine counterparty risks in these markets and ensure that local banks have alternatives to foreign funding if they are temporarily cut off from these markets. Extending guarantees to cover trade finance in the event of a cutoff should also be considered.

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• ***Strengthening risk management.*** With slowing growth, corporate default rates and nonperforming loans can be expected to rise. Regional banks with exposure to sectors that are especially vulnerable to a domestic slowdown, such as housing and small and medium-sized enterprises, may be at greater risk. Supervisors will need to ensure that local banks properly classify loans and set aside adequate provisions for problem loans.

• ***Standing ready to recapitalize banking systems, if needed.*** At this stage, the possibility of a larger than expected wave of corporate defaults leading to bank failures cannot be ruled out. Authorities should thus consider contingency plans, if public funds are required to prop up the capital base of financial institutions.

• ***Implementing longer-term financial reforms.*** Although the crisis is still unfolding and lessons are still being learned, policymakers may take this opportunity to implement longer-term reforms to strengthen their financial systems. These might include strengthening risk-based supervision, addressing the procyclical risks from leverage, further developing local bond markets, and enhancing the monitoring of systemically important institutions, including those outside the banking system. ■

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